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A Risk-Based Approach to Mandatory Arbitration

In recent years, the Supreme Court has upheld contractual provisions that require mandatory, binding arbitration of employment discrimination claims.¹ In the wake of these decisions, many legal academics have condemned this practice, arguing that the mandatory arbitration of discrimination disputes violates public policy and possibly even due process.² These critics assert

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¹ See *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 109 (2001); *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 27-30 (1991). This Article considers arbitration provisions that employees must sign as a condition of employment. Although “mandatory” is perhaps a misnomer, I follow the literature and refer to these predispute arbitration agreements as mandatory.

² See, e.g., Thomas E. Carbonneau, *Arbitral Justice: The Demise of Due Process in American Law*, 70 TUL. L. REV. 1945, 1967 (1996); Charles L. Knapp, *Taking Contracts Private: The Quiet Revolution in Contract Law*, 71 FORDHAM L. REV. 761, 766 (2002); Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 643 (1996) [hereinafter Sternlight, *Panacea*]; Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L. REV. 1 (1997) [hereinafter Sternlight, *Constitutionality*]; Katherine Van Wezel Stone, *Mandatory Arbitration of Individual Employment Rights: The Yellow Dog Contract of the 1990s*, 73 DENV. U. L. REV. 1017, 1049 (1996); Christine M. Reilly, Comment, *Achieving Knowing and Voluntary Consent in Pre-Dispute Mandatory Arbitration Agreements at the Contracting Stage of Employment*, 90 CAL. L. REV. 1203, 1224 (2002); see also Sarah Rudolph Cole, *Incentives and Arbitration: The Case Against Enforcement of Executory Arbitration Agreements Between Employers and Employees*, 64 UMKC L. REV. 449, 454 (1996); Geraldine Szott Moohr, *Arbitration and the Goals of Employment Discrimination Law*, 56 WASH. & LEE L. REV. 395, 439

that arbitration strips the employee of important procedural protections and, in doing so, benefits the employer at the employee's expense.³ On the other hand, advocates of mandatory arbitration argue that mandatory arbitration can make both the employer and the employee better off.⁴

What has not been stressed in this debate is how mandatory arbitration allows employers to manage risk. Employers claim that mandatory arbitration—because it can eliminate the jury trial, class actions, and large attorney's fees—allows them to avoid the “risk” associated with litigating an employment discrimination dispute.⁵

The filing of a discrimination claim depends on factors that the employer cannot perfectly predict or control, such as the actions of the employer's agents and the employee's proclivity to file suit. Through mandatory arbitration, the employer limits its exposure if there is discrimination or the perception of discrimination in the workplace. Put another way, mandatory arbitration

(1999); David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 38, 110-15 (1997); Jean R. Sternlight, *Mandatory Binding Arbitration and the Demise of the Seventh Amendment Right to a Jury Trial*, 16 OHIO ST. J. ON DISP. RESOL. 669, 669-72 (2001) [hereinafter Sternlight, *Jury Trial*].

The debate over mandatory arbitration extends beyond academia. See Russell D. Feingold, *Mandatory Arbitration: What Process is Due?*, 39 HARV. J. ON LEGIS. 281, 292 (2002) (describing recent legislative proposals designed to curtail the use of mandatory arbitration in employment contracts).

³ See, e.g., Schwartz, *supra* note 2, at 59-67.

⁴ See Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 S. CT. ECON. REV. 209, 225 (2000). For other scholars offering a sympathetic view of mandatory arbitration, see Christopher R. Drahozal, “Unfair” Arbitration Clauses, 2001 U. ILL. L. REV. 695 (2001); Samuel Estreicher, *Predispute Agreements to Arbitrate Statutory Employment Claims*, 72 N.Y.U. L. REV. 1344 (1997); Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate over Predispute Employment Arbitration Agreements*, 16 OHIO ST. J. ON DISP. RESOL. 559 (2001) [hereinafter Estreicher, *Rickshaws*]; Michael Z. Green, *Debunking the Myth of Employer Advantage from Using Mandatory Arbitration for Discrimination Claims*, 31 RUTGERS L.J. 399 (2000); Lewis L. Maltby, *Private Justice: Employment Arbitration and Civil Rights*, 30 COLUM. HUM. RTS. L. REV. 29, 62 (1998); Theodore J. St. Antoine, *Mandatory Arbitration of Employee Discrimination Claims: Unmitigated Evil or Blessing in Disguise?*, 15 T.M. COOLEY L. REV. 1 (1998); see generally Richard E. Speidel, *Consumer Arbitration of Statutory Claims: Has Pre-Dispute Mandatory Arbitration Outlived Its Welcome?*, 40 ARIZ. L. REV. 1069 (1998).

⁵ See Schwartz, *supra* note 2, at 63; Thomas J. Stipanowich, *Punitive Damages and the Consumerization of Arbitration*, 92 NW. U. L. REV. 1, 3 (1997); see also Francis J. Mootz III, *Insurance Coverage of Employment Discrimination Claims*, 52 U. MIAMI L. REV. 1, 2 (1997) (“For many employers, managing this risk of liability is a vital part of their human resources mission and an important part of their general corporate cost-control program.”).

functions as a risk-management device for the employer. To date, scholars have largely ignored this role played by mandatory arbitration.⁶ By linking the uncertainty of discrimination claims and the risk-management function of mandatory arbitration, this Article offers insights into two puzzles unanswered in the literature and heated policy debate over these provisions.

First, some employers do not use mandatory arbitration.⁷ If, as the critics argue, mandatory arbitration benefits the employer at the expense of the employee, why doesn't every employment contract include an arbitration provision?

Second, employers in discrimination cases prevail more on summary judgment than any other kind of defendant. The puzzle is why employers do so well in the litigation of employment discrimination disputes.⁸ The leading explanation is judicial bias against discrimination plaintiffs. Judges, the theory goes, do not like plaintiffs who bring discrimination claims; accordingly, they abuse the summary judgment standard to get rid of the claims.

When tackling these two puzzles from the risk-management premise, the question becomes whether mandatory arbitration adequately accounts for the problems of asymmetric information inherent to any risk-management scheme.⁹ To see this point, consider another, albeit different, way to manage risk: insurance.

⁶ In passing, a few commentators have noted the risk-reducing role of arbitration. See Edward Brunet, *Seeking Optimal Dispute Resolution Clauses in High Stakes Employment Contracts*, 23 BERKELEY J. EMP. & LAB. L. 107, 119, 122 (2002); Schwartz, *supra* note 2, at 63; Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1, 5 (1995); Marcela Noemi Siderman, Comment, *Compulsory Arbitration Agreements Worth Saving: Reforming Arbitration to Accommodate Title VII Protections*, 47 UCLA L. REV. 1885, 1914-15 (2000). None of these commentators fully consider the implications of viewing arbitration as a risk-management device. Instead, they suggest that employers prefer mandatory arbitration for other reasons, including: (1) reduced litigation costs; (2) faster dispute resolution; (3) less publicity if the employee prevails; (4) the lack of a published opinion; (5) the benefits that the employer reaps because it is a "repeat player" at arbitration; (6) the ability to preclude class actions; and (7) the ability to avoid dispute resolution by imposing all or part of the arbitration fees on the employee. See, e.g., Sternlight, *Jury Trial*, *supra* note 3, at 681-87; Schwartz, *supra* note 3, at 59-62.

⁷ See *infra* note 103 and accompanying text (discussing the number of employers that use mandatory arbitration).

⁸ For the data on discrimination case outcomes, see the discussion of Stewart Schwab's work, *infra* note 104.

⁹ Asymmetric information refers to "situations where one economic agent knows something that another economic agent doesn't." HAL R. VARIAN, MICROECONOMIC ANALYSIS 440 (3d ed. 1992). Economists have coined the two problems of asymmetric information as "moral hazard" and "adverse selection." See *infra* notes 65-73 and accompanying text (discussing both concepts).

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In every insurance market, the insurer tries to target the cost of the insurance to the risk the insured presents. If, however, because of asymmetric information, the cost of the insurance fails to reflect an individual's specific risk level, the market will have a tendency to unravel, with only the high-risk individuals remaining in the insurance pool.

Today, the mandatory arbitration system does not account for employer-specific risk. Because of this fact, this Article predicts that the market will have a tendency to separate. The employers that gain the most from arbitration (the discrimination-prone or high-risk employers) will use mandatory arbitration. On the other hand, low-risk employers, because they do not want to pay the price implicit in mandatory arbitration (since it does not reflect their specific risk level), will forgo the risk-averting benefits of arbitration and take their chances with litigation. High-risk employers arbitrate; low-risk employers litigate.¹⁰ The discrimination case outcomes, then, do not reveal judicial bias or an abuse of the summary judgment standard. Instead, the case outcomes reflect the merits of the underlying pool of discrimination claims being litigated.¹¹

More important, the self-selection of high-risk employers out of litigation is potentially problematic for the development of discrimination case law. With self-selection, the case law is based on an unrepresentative sample of employers (the low-risk employers only). As a result, the doctrine might skew in favor of employers, despite continued and unchanging discriminatory conduct across a broader array of employers.

In addition to this separation idea, a risk-based analysis of mandatory arbitration offers three further insights and a reform proposal. First, under this analysis, employers that are frequently called into arbitration should do progressively worse over time. This result stands in stark contrast to the conventional view re-

¹⁰ In discussing the empirical evidence about mandatory arbitration, Steve Ware recognized that the cases going to litigation might systematically differ from cases going to arbitration. See Stephen J. Ware, *The Effects of Gilmer: Empirical and Other Approaches to the Study of Employment Arbitration*, 16 OHIO ST. J. ON DISP. RESOL. 735, 757 (2001). This Article provides a theoretical justification for a particular type of employer self-selecting into arbitration. As explained *infra* notes 110-11 and accompanying text, the market segmentation result does not hinge on the employer paying a higher wage to employees who agree to mandatory arbitration.

¹¹ The theory offers a testable and counterintuitive rationale for the discrimination case outcomes. The model predicts that employers that have a history of discrimination claims should be more inclined to use mandatory arbitration.

garding the so-called “repeat player” effect: the idea that arbitrators are inherently biased in favor of parties that frequently engage in arbitration.¹² Viewed in terms of risk management, the repeat player (or, more precisely, the repeat discriminator¹³) should actually pay more to use mandatory arbitration because it poses, statistically speaking, a greater threat of discrimination. The reason is that a long history of discrimination claims reveals information about the propensity to discriminate of that employer’s agents.

Here, a rough analogy to the automobile insurance market is illustrative. The driver involved in six accidents in the same year pays more for insurance than the accident-free driver. Likewise, the employer that faces six discrimination suits in the same year should have to pay more than the employer that faces one discrimination suit per year for the risk-management benefits mandatory arbitration offers. Yet, the available empirical evidence reveals the existence of a repeat-player advantage, not a repeat-player disadvantage.¹⁴ To combat this problem, this Article proposes that arbitrators consider the employer’s discrimination history when fashioning the arbitration award.¹⁵

¹² See Lisa B. Bingham, *On Repeat Players, Adhesive Contracts, and the Use of Statistics in Judicial Review of Employment Arbitration Awards*, 29 MCGEORGE L. REV. 223, 223-24 (1998) (describing the advantages that repeat players have in arbitration); Bryant G. Garthy, *Tilting the Justice System: From ADR as Idealistic Movement to a Segmented Market in Dispute Resolution*, 18 GA. ST. U. L. REV. 927, 934 (2002) (same); Carrie Menkel-Meadow, *Do the “Haves” Come Out Ahead in Alternative Judicial Systems?: Repeat Players in ADR*, 15 OHIO ST. J. ON DISP. RESOL. 19, 20 (1999) (same). See generally Marc Galanter, *Why the “Haves” Come out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC’Y REV. 95, 149 (1974) (arguing that the “legal system tends to confer interlocking advantages on overlapping groups [i.e., the repeat players]”). The argument underlying the “repeat player” contention usually assumes one of two forms. First, arbitrators will have a tendency to favor frequent players in arbitration in order to ensure repeat business. Second, by frequently engaging in arbitration, a repeat player gains expertise at the arbitration “game,” enabling it to better use the system.

¹³ In this Article, the phrase “repeat discriminator” refers to companies against whom multiple discrimination claims have been filed, independent of the claims’ merit. The idea of the repeat discriminator has nothing to do with discrimination broadly defined. It is a claim-based concept.

¹⁴ See Bingham, *supra* note 12, at 238 (“Among employee claims against employers, repeat player employers do better in employment arbitration than non-repeat player employers.”); see also Lisa B. Bingham, *Employment Arbitration: The Repeat Player Effect*, 1 EMPLOYEE RTS. & EMP. POL’Y J. 189 (1997) (same).

¹⁵ Under our current system, past acts of discrimination are not explicitly considered at arbitration. Like a judicial proceeding, the arbitration hearing focuses on the facts of the case at hand.

Second, a risk-management approach lends some needed precision to the unconscionability analysis of mandatory arbitration provisions. In analyzing arbitration provisions for unconscionability, courts focus on several factors, including the relative bargaining power of the two parties, whether the arbitration agreement is substantially one-sided, and the number of rights afforded to the employee in arbitration.¹⁶ A risk-based analysis can help screen valid arbitration provisions from invalid provisions by informing the meaning of “one-sided.”

Finally, this new perspective clarifies why mandatory arbitration agreements are different in kind from postdispute agreements to arbitrate. In a workplace governed by mandatory arbitration, the employer has a diminished incentive to closely monitor and select its employees because it knows that arbitration, not litigation, will be used to resolve disputes.¹⁷ Postdispute arbitration agreements do not raise the same incentive concerns.¹⁸

This Article proceeds in four parts. Part I summarizes the legal landscape. It discusses the case law establishing the validity of contracts that require the arbitration of discrimination claims as a condition of employment. Part II sets forth the conventional wisdom about mandatory arbitration, detailing the arguments commonly made by critics and proponents of mandatory arbitration. The bulk of the Article, Part III, challenges the conventional wisdom and explores the implications of the risk-based analysis. Part III starts by developing the basic asymmetric information framework. It then discusses how this framework sheds light on (1) the role arbitration plays in maintaining incentives to avoid discrimination; (2) the repeat player effect; (3) market segmentation; (4) the adequacy requirement for arbitral forums; (5) the unconscionability doctrine; and (6) the difference between predispute and postdispute agreements. Part IV considers the

¹⁶ See, e.g., *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 893 (2002); *Ferguson v. Countrywide Credit Indus.*, 298 F.3d 778, 784 (2002). But see *Cole v. Burns Int’l Sec. Serv.*, 105 F.3d 1465, 1482 (1997) (holding, without mentioning unconscionability, that “statutory rights [i.e., Title VII] include both a substantive protection and access to a neutral forum”).

¹⁷ As discussed *infra* notes 77-78 and accompanying text, mandatory arbitration in an adequate arbitral forum mitigates this incentive problem.

¹⁸ My discussion of incentive effects is limited to the employment context. Steven Shavell makes a compelling argument that, in many situations, predispute agreements to arbitrate create beneficial incentive effects. Shavell, *supra* note 6, at 5.

relationship between mandatory arbitration and other risk-management mechanisms, in particular, liability insurance.

I

THE FEDERAL ARBITRATION ACT AND *GILMER*

In 1925, Congress passed the Federal Arbitration Act (FAA).¹⁹ The FAA's purpose "was to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements upon the same footing as other contracts."²⁰ To accomplish this goal, the substantive portion of the FAA states:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.²¹

Procedurally, the FAA grants district courts the authority to (1) stay a judicial proceeding if that proceeding involves an issue that is potentially subject to arbitration²² and/or (2) compel arbitration "when one party has failed, neglected, or refused to comply with an arbitration agreement."²³ According to the Supreme Court, these substantive and procedural provisions evidence a "liberal federal policy favoring arbitration agreements."²⁴

The Supreme Court first applied the policy favoring arbitration to discrimination claims in *Gilmer v. Interstate/Johnson Lane Corp.*²⁵ In *Gilmer*, the plaintiff, Robert Gilmer, alleged that his employer had violated the Age Discrimination in Employment Act (ADEA) when it terminated his employment. As a condition of his employment, Gilmer registered with several stock ex-

¹⁹ Federal Arbitration Act, 9 U.S.C. §§ 1-16 (2000). The Act was originally known as the U.S. Arbitration Act. In 1947, Congress codified the Act as Title 9. In this codification, Congress deleted the section of the statute naming it the U.S. Arbitration Act. Since then, the Act has been commonly referred to as the Federal Arbitration Act. See Sternlight, *Panacea*, *supra* note 2, at n.12.

²⁰ *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991).

²¹ 9 U.S.C. §§ 2-3 (2000).

²² *Id.* § 4.

²³ *Gilmer*, 500 U.S. at 25.

²⁴ *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

²⁵ 500 U.S. at 20.

changes.²⁶ The registration application contained a boilerplate clause requiring Gilmer to arbitrate “[a]ny controversy between a registered representative [i.e., Gilmer] and any member or member organization [i.e., Interstate] arising out of the employment or termination of employment of such registered representative.”²⁷ The issue in *Gilmer* was whether an ADEA claim could be subject to mandatory arbitration.²⁸

In a seven-to-two decision, the Court held that Gilmer’s ADEA claim was arbitrable.²⁹ Reasoning from precedent that allowed for the arbitration of other statutory claims, the Court declared that “[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.”³⁰ The Court further opined that “[h]aving made the bargain to arbitrate, the party should be held to it unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue.”³¹ Finding nothing in the ADEA’s text or legislative history indicating an intent to preclude arbitration, the Court rejected the argument that mandatory arbitration was inconsistent with the purpose of the ADEA.³²

Although *Gilmer* upheld the mandatory arbitration of a discrimination claim, the Court did not preclude every type of challenge to these provisions.³³ After *Gilmer*, a plaintiff could still seek revocation of a mandatory arbitration agreement on gener-

²⁶ *Id.* at 23.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 26 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985)).

³¹ *Id.* (quoting *Mitsubishi*, 473 U.S. at 628).

³² *Id.* at 27.

³³ *Gilmer* left open a number of issues that the Court has since resolved.

First, section 1 of the FAA contains an exclusionary clause, providing that “nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.” Federal Arbitration Act, 9 U.S.C. § 1 (2000). According to the majority, this clause did not apply in *Gilmer* because the arbitration clause was not in a “contract for employment,” but rather in a registration application with the securities exchanges. *Gilmer*, 500 U.S. at 25 n.2. Thus, the *Gilmer* Court did not address the textual argument that the plain meaning of the exclusionary clause meant that the FAA did not apply to employment contracts. In *Circuit City Stores, Inc. v. Adams*, the Court tackled this argument and construed the exclusionary clause to apply to employment contracts with “transportation workers” only. 532 U.S. 105, 109 (2001).

ally applicable contract law grounds, such as duress, unconscionability, or fraud.³⁴ For simplicity, I refer to this exception as the “contract-based” exception to enforceability. In addition, a plaintiff could still challenge the adequacy of a particular arbitration proceeding.³⁵ This exception will be referred to as the “adequacy-based” exception to enforceability.

Since *Gilmer*, the debate over mandatory arbitration provisions has centered on these two exceptions. Nonetheless, because the Supreme Court has left these two exceptions undefined, lower courts have struggled to distinguish between valid and invalid arbitration agreements.³⁶

More important for my purposes, the language of *Gilmer* reflects an unstated premise. The Court views arbitration as a

Restated, the Court held that the FAA was applicable to all employment contracts, except those for “transportation workers.”

Second, *Gilmer* did not resolve the issue of preemption. Was a state law targeting mandatory arbitration provisions for special treatment inconsistent with the FAA and hence preempted? In *Doctor's Associates, Inc. v. Casarotto*, the Court answered this question affirmatively. The Court held that “Montana’s first-page notice requirement, which governs not ‘any contract,’ but specifically and solely contracts ‘subject to arbitration,’ conflicts with the FAA and is therefore displaced by the federal measure.” 517 U.S. 681, 683 (1996); see also *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 281 (1995).

Third, *Gilmer* did not resolve the issue of arbitration fees. Under the NYSE rules at issue in *Gilmer*, “it was the standard practice for securities industry parties, arbitrating employment disputes, to pay all of the arbitrators’ fees.” *Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 94 (2000) (Ginsburg, J. dissenting). Accordingly, the Court did not consider whether the allocation of fees affected the enforceability of a mandatory arbitration agreement. There is, however, a concern about the fee structure of these agreements. A party might, for instance, foreclose access to the arbitral forum (and therefore *any* forum) by requiring the opposing party to pay all the fees associated with arbitration. In *Green Tree*, the Supreme Court placed the burden of showing the likelihood of “prohibitively expensive” arbitration fees on the party seeking to invalidate the arbitration agreement. 531 U.S. at 92.

³⁴ 9 U.S.C. § 2; see also *Gilmer*, 500 U.S. at 33.

³⁵ *Koveleskie v. SBC Capital Mkts., Inc.*, 167 F.3d 361, 364 (7th Cir. 1999); accord *Murray v. United Food and Commercial Workers Int’l Union*, 289 F.3d 297, 302 (4th Cir. 2002) (“And, of course, agreements to arbitrate federal statutory claims, such as those pursued under Title VII, may be revoked if the prospective litigant demonstrates that it cannot ‘effectively . . . vindicate his or her statutory cause of action in the arbitral forum.’”) (quoting *Green Tree Fin. Corp.-Ala.*, 531 U.S. at 89); *Cole v. Burns Int’l Sec. Servs. Int’l*, 105 F.3d 1465, 1482 (D.C. Cir. 1997) (holding that “statutory rights include both a substantive protection *and* access to a neutral forum in which to enforce those protections”). Note, too, that the adequacy exception only applies to the arbitration of federal statutory claims.

³⁶ As this Article will demonstrate, a risk-based analysis informs both these exceptions. See *infra* Part III.E.

“contracted-for” substitute for litigation.³⁷ To reiterate, the Court will uphold a mandatory arbitration provision “[s]o long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum.”³⁸ By speaking in terms of vindication, the Court focuses on whether the arbitration procedure at issue is a “good enough” substitute for litigation.³⁹ If, however, risk-management is one purpose of mandatory arbitration, a comparison to litigation is incomplete. In employment cases, the court should also ask whether the arbitration procedure is a “good enough” substitute for other risk-management devices—such as, say, liability insurance. Before exploring the implications of this benchmark change, I first review and criticize the conventional wisdom regarding mandatory arbitration.

II

THE CONVENTIONAL WISDOM

A. *The Critics*

The conventional wisdom espoused by critics of mandatory arbitration starts from consent. First, critics note that mandatory arbitration provisions are often buried in the fine print of contracts of adhesion.⁴⁰ As a result, employees are unlikely to read,

³⁷ The Court has expressed this view of arbitration in a number of cases besides *Gilmer*. See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 229 (1987) (stating that “[t]he decision in *Scherk* thus turned on the Court’s judgment that under the circumstances of that case, arbitration was an adequate substitute for adjudication as a means of enforcing the parties’ statutory rights”); *Gateway Coal Co. v. United Mineworkers of Am.*, 414 U.S. 368, 378 (1974) (noting that “commercial arbitration and labor arbitration have different objectives. In the former case, arbitration takes the place of litigation, while in the latter ‘arbitration is the substitute for industrial strife’”) (quoting *United Steelworkers of Am. v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 578 (1960)); see also Michael H. Leroy & Peter Feuille, *When Is Cost an Unlawful Barrier to Alternative Dispute Resolution? The Ever Green Tree of Mandatory Employment Arbitration*, 50 UCLA L. REV. 143, 149 (2002) (“The Court has consistently viewed arbitration as a cost-saving alternative to litigation.”). Most commentators share this view of arbitration. See, e.g., Moohr, *supra* note 2, at 402 (“Arbitration is . . . a substitute, or alternative, for formal, public adjudication.”).

³⁸ *Gilmer*, 500 U.S. at 28 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth, Inc.*, 473 U.S. 614, 637 (1985)).

³⁹ See *Shearson/Am. Express, Inc.*, 482 U.S. at 229.

⁴⁰ An adhesion contract is:

(1) a standardized (typed or printed) form document (2) drafted by, or on behalf of, one party which (3) participates routinely in numerous like transactions and (4) presents the form to the other, ‘adhering’ party on a take-it-

understand, or fully appreciate the consequences of agreeing to an arbitral forum.⁴¹ The employer—preying on the employee’s lack of knowledge—will have a tendency to draft an arbitration provision that disproportionately favors its interests.⁴² In the end, the employee’s choice is between a job in which employment discrimination disputes are arbitrated and no job whatsoever.⁴³ Such a choice is really no choice at all.

A second level of the conventional criticism can be roughly categorized into four process-based arguments. First, critics stress that mandatory arbitration often reduces the value of the employee’s claim by limiting the scope of available relief, denying class actions, and restricting discovery.⁴⁴ Second, critics argue that the lack of a written opinion in arbitration impedes the scope of judicial review, which is already limited under the FAA.⁴⁵ Third, critics point out that arbitration inhibits the creation of precedent by diverting cases from litigation into arbitration.⁴⁶ Finally, critics worry about the privacy of arbitration proceedings, declaring that litigation is beneficial precisely because of its public nature.⁴⁷ Under this view, litigation informs the public about the undesirable characteristics of the “wrongdoing” employer and draws a line between permissible and impermissible employment practices.⁴⁸

Finally, a third level of criticism is constitutional. Scholars have suggested that mandatory arbitration may violate the Due

or-leave-it basis; (5) the adhering party enters into few transactions of the type in question, and (6) the adhering party signs the form after dickering over the few terms, if any, that are open to bargaining.

Schwartz, *supra* note 2, at 55.

⁴¹ Sternlight, *Panacea*, *supra* note 2, at 676.

⁴² *Id.* at 680-82; Cole, *supra* note 2, at 475-76.

⁴³ Reilly, *supra* note 2, at 1258 (“Giving up one’s right to a judicial forum versus giving up one’s job is hardly a voluntary choice, particularly when such clauses have become boilerplate language in employment contracts. Such a ‘choice’ is naturally coercive and therefore involuntary.”); Richard C. Reuben, *Constitutional Gravity: A Unitary Theory of Alternative Dispute Resolution and Public Civil Justice*, 47 UCLA L. REV. 949, 1026 (2000).

⁴⁴ Sternlight, *Panacea*, *supra* note 2, at 638.

⁴⁵ Speidel, *supra* note 4, at 1090 (suggesting that the FAA be amended to require a written award to “insure that the actual implementation of [statutory] rights in arbitration approximates the remedies that the individual would otherwise get in court”).

⁴⁶ Sternlight, *Panacea*, *supra* note 2, at 686; Moohr, *supra* note 2, at 432, 436.

⁴⁷ Moohr, *supra* note 2, at 436-38.

⁴⁸ *Id.* at 437.

Process Clause or the Seventh Amendment right to a jury trial.⁴⁹ Though not fitting neatly into any criticisms listed thus far, David Schwartz has also argued that adhesive mandatory arbitration provisions represent impermissible prospective waivers of statutory rights.⁵⁰

B. *The Proponents*

Not surprisingly, the conventional wisdom offered by proponents of mandatory arbitration starts from freedom of contract. Proponents argue that employees and employers will only agree to mandatory arbitration if the agreement makes them both better off.⁵¹ If the total expected cost of litigation is greater than the total expected cost of arbitration, a mandatory arbitration agreement creates a surplus.⁵² The parties can then share this surplus to ensure that both parties are better off arbitrating instead of litigating.⁵³ In other words, even assuming that the employee is generally worse off in arbitration, if arbitration makes the employer sufficiently better off, the employer can simply pay the employee enough to make her indifferent between arbitration and litigation. This Coasian analysis lies at the heart of the proponent's argument that mandatory arbitration is efficient and socially desirable.⁵⁴

In a different vein, Samuel Estreicher advocates mandatory ar-

⁴⁹ Sternlight, *Constitutionality*, *supra* note 2, at 69-77, 80-98.

⁵⁰ Schwartz, *supra* note 2, at 110-25.

⁵¹ Hylton, *supra* note 4, at 224-25; Drahozal, *supra* note 4, at 744-46. Strictly speaking, Drahozal should be not classified as a "proponent" of mandatory arbitration. In the Illinois piece, Drahozal demonstrates that whether arbitration clauses are efficient depends on the underlying market structure. Drahozal, *supra* note 4, at 764 ("If the market is ineffective, arbitration not only may not benefit individuals, it actually may make the parties worse off; the corporation's gain may be more than offset by the individual's loss.").

⁵² Hylton, *supra* note 4, at 225-26; Drahozal, *supra* note 4, at 746.

⁵³ Hylton, *supra* note 4, at 223; Drahozal, *supra* note 4, at 745-46.

⁵⁴ Hylton, *supra* note 4, at 222; *see also* Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). To illustrate, suppose that it costs each party \$25 to arbitrate and \$50 to litigate. Further suppose that, with a mandatory arbitration agreement in place, the employer's agent discriminates for sure, causing \$60 worth of damage. Assume that the arbitrator favors the employer. Accordingly, the arbitrator only awards \$30 worth of damages to the employee. In contrast, if the employer discriminates and the case is litigated, the employer pays the full \$60 in damages. Under these conditions, mandatory arbitration is efficient—it saves \$50 of dispute resolution costs while imposing \$30 in additional damages. As a result, if the employer paid the employee \$30 or more to agree to mandatory arbitration, both the employer and the employee would be better off arbitrating instead of litigating.

bitration on pragmatic grounds. Estreicher recognizes that the stakes of most discrimination claims are too small to attract the attention of attorneys.⁵⁵ The plaintiffs' bar, therefore, can be selective among claimants, only taking on those cases with a large settlement value.⁵⁶ In Estreicher's opinion, the average claimant does not get much of anything through litigation.⁵⁷ The beneficiaries of the litigation model of dispute resolution are high-salaried claimants and plaintiff's attorneys. In contrast to litigation, Estreicher asserts that the average claimant benefits from arbitration. In his view, arbitration offers a lower-cost forum, resulting in a lower cost of representation.⁵⁸ As a consequence, the average claimant is able to find an attorney to take her case to arbitration. Moreover, Estreicher maintains that the prompt resolution of claims in arbitration is "more suitable for claims by incumbent employees or even former employees truly desiring reinstatement."⁵⁹

In the conventional debate, commentators on both sides miss the chief benefit of mandatory arbitration—managing risk. Commentators have a simple discrimination story in mind—the employer discriminates and the employee sues. This story neglects the randomness of most discrimination claims and, hence, the interaction of risk and mandatory arbitration. Two factors contribute to the uncertainty of discrimination claims.

First, before hiring, the employer cannot assess the applicant's proclivity to file suit. The applicant's decision to file turns on a host of factors, many of which the employer is unable to predict. These factors—which vary from applicant to applicant—include: (1) the applicant's perceptions about what constitutes discrimination; (2) the applicant's willingness to subject herself to dispute resolution; (3) the applicant's ability to read, understand, and enforce her rights; and (4) the applicant's ability to retain an attorney.⁶⁰

⁵⁵ Estreicher, *Rickshaws*, *supra* note 4, at 563. Theodore St. Antoine has made the same pragmatic argument. St. Antoine, *supra* note 4, at 6-8. See also David Sherwyn et al., *In Defense of Mandatory Arbitration of Employment Disputes: Saving the Baby, Tossing out the Bath Water, and Constructing a New Sink in the Process*, 2 U. PA. J. LAB. & EMP. L. 73 (1999).

⁵⁶ Estreicher, *Rickshaws*, *supra* note 4, at 564.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ See John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 STAN. L. REV. 983, 993 (1991) ("To raise a bona

Second, after hiring, the employer does not have complete control over the activities of its employees.⁶¹ The divergence between the interests and preferences of many of the employees and the interests of the employer, combined with imperfect monitoring, means that employers cannot eliminate the chance of actual discrimination or the perception of discrimination in the workplace.

The existence of a robust liability insurance market for discrimination claims provides further evidence of the uncertain nature of these claims.⁶² Insurance markets work because insurers diversify away the risk of uncertain events. In the insurance market for discrimination claims, insurers bet that some employers will face claims and others will not. Neither insurers nor employers can predict perfectly which employers will be subject to a claim.⁶³

With this uncertainty in mind, the bulk of the next section considers how mandatory arbitration enables employers to manage risk.

III

USING MANDATORY ARBITRATION TO MANAGE RISK

Before turning to the risk-based analysis of mandatory arbitration, a brief description of an insurance model helps to frame the discussion. The model is used to highlight problems of asymmetric information. These problems arise under three conditions: (1) one party agrees to bear a risk, (2) the probability that the risk will materialize depends on another party's actions or latent characteristics, and (3) information asymmetries make it hard to contract on these actions or latent characteristics.⁶⁴ With insur-

fide claim of employment discrimination, a worker must first perceive that discrimination has occurred. Clearly, the ability to detect violations of one's rights—and, once detected, to categorize such violations as legally actionable—depends not only on the grossness of the violation but also on one's education, legal sophistication, and general perceptions of one's rights.”).

⁶¹ Note, too, that neither the applicant nor the employer can perfectly predict the actions of the other employees of the business. This makes the possibility of discrimination and the filing of a claim an uncertain event in the eyes of the employer and the applicant.

⁶² See L. Kathleen Chaney, *Employment Practices Liability Insurance*, COLO. LAW., July 2001, at 125 (describing the rapid expansion of this insurance market).

⁶³ Cf. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 218 (6th ed. 2003).

⁶⁴ Information asymmetries make the party's actions or latent characteristics ei-

ance, for example, the insured pays a premium and transfers the risk of the insured-against event to the insurer. The insured's actions and latent characteristics influence the chance that the insured-against event will take place. And, finally, it is sometimes hard to write a contract whose payment is contingent on the insured's actions and latent characteristics. I discuss these conditions in more depth below.

In the case of mandatory arbitration, a similar transaction takes place. Through mandatory arbitration, the employer transfers to the employee some of the risk of discriminatory conduct in the workplace. The employer's actions and characteristics influence whether or not there is discrimination in the workplace. That is, the employer's monitoring, training, and selecting its workforce impacts whether an employee suffers discrimination or perceives she has suffered discrimination. Last, most mandatory arbitration provisions do not account for actions taken by an employer to avoid discrimination claims.

The notion that the employee bears the risk of discrimination is counterintuitive. As between the employee and the employer, the thinking is that the employee is more risk averse; as a result, any risk should be borne by the employer. We often observe, however, employees explicitly agreeing to take on risk created in the workplace. In the case of dangerous occupations, for example, the employee agrees to an increased risk of bodily injury in return for higher wages. The attributes of the workplace create the dangerous occupation. Yet the employee, not the employer, bears any risk above the level covered by worker's compensation. And this is true despite the fact that the employee is thought to be more risk averse than the employer. The same argument applies to mandatory arbitration.

A. Illustrating the Problems of Asymmetric Information: The Case of Insurance

Begin by assuming there is a single agent. Further, assume that there are two states of nature: bad and good. In the bad state, the agent's house burns down and she suffers a loss equal

ther unobservable or unverifiable to the court or other third-party enforcer. The parties, then, cannot write an enforceable contract that is contingent on those actions or characteristics. This is what creates the problem. See discussion of asymmetric information and insurance, *infra* notes 66-73. For the rest of the discussion I do not distinguish between actions and characteristics that are "unobservable" and those that are "unverifiable."

to \$1,000. In the good state, there is no fire; consequently, the agent suffers no loss. If the agent is risk averse, she is willing to pay a premium greater than her expected loss (i.e., the probability of the fire multiplied by the loss) in the bad state to equalize her wealth across the good and bad states. In other words, she will fully insure.⁶⁵ In this stylized example, the agent's actions did not influence whether or not the fire took place.

Now consider the case in which the agent can engage in some risk-reducing activity (e.g., not smoking in bed) that alters the probability that the good state will occur.⁶⁶ If the insurer can observe and verify to the court the agent's actions, this additional wrinkle poses no problem. The insurer can make the payment on the insurance contract contingent on the agent's engaging in the risk-reducing activity.⁶⁷ The agent, in effect, gets complete insurance coverage if and only if she engages in the "right" amount of risk-reducing activities.

If the agent's actions are unobservable—that is, the insurer is unable to determine whether the agent is engaging in risk-reducing activities—the insurance contract becomes more complicated. Because the actions are unobservable, the optimal contract no longer provides full insurance. Instead, the optimal contract imposes some risk on the agent to induce her to undertake risk-reducing activities. If the fire occurs, for example, the agent might have to pay a fraction of the total loss, forcing the agent to internalize partially the cost of not engaging in risk-reducing activities.⁶⁸ Under this contract, the risk-averse agent still reaps some of the benefits of insurance—she does not suffer the entire loss from the fire. Nonetheless, the fractional payment, whether in the form of a deductible or a co-insurance payment, gives the agent an incentive to engage in risk-reducing activities. This contract illustrates the fundamental tradeoff between risk and incentive. To give the agent the proper incentives, the contract makes sure that she bears some of the loss if the bad state

⁶⁵ See ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 187-88 (1995).

⁶⁶ For a model of this sort, see VARIAN, *supra* note 10, at 455-57. The propositions outlined above come directly from the principal-agent literature. In this context, the principal is the insurer and the agent is the insured.

⁶⁷ For this result in a general principal-agent model, see Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. OF ECON. 74, 76 (1979).

⁶⁸ See *id.* at 80 ("Optimal accident insurance policies necessarily entail deductibles in the presence of moral hazard.").

occurs.⁶⁹ The more the agent's actions influence the probability that the bad state will occur, the greater the need to give the agent an incentive to engage in risk-reducing activities. Accordingly, economists have demonstrated that the amount of risk imposed under the optimal contract depends, in part, on the degree to which the agent's actions affect the probability of the uncertain outcome.⁷⁰

In addition to the agent's actions, the agent's latent characteristics may also influence the chance that the bad state will occur. With health insurance, for example, an agent might be particularly susceptible to illness. She would therefore represent a higher risk than others in the health insurance pool. In and of itself, different susceptibility to injury does not present a problem for the insurer. If the agent's characteristics are observable and verifiable, the insurer can simply set the premium to reflect the agent's specific risk. For example, the chronically ill person pays more for health insurance than the person who never gets sick.

Here again, a problem arises when there is asymmetric information between the insurer and the agent. Suppose that the insurance pool consists of high-risk and low-risk applicants and the insurer cannot tell the difference between the two types of applicants.⁷¹ Under these conditions, the insurer will set the premium to reflect the average risk of the potential members of the pool. As a result, the low-risk applicant will pay too much for the insurance and the high-risk applicant will pay too little. Accordingly, some low-risk applicants will have an incentive to opt out of the insurance scheme altogether, resulting in a higher proportion of high-risk applicants in the insurance pool. This shift in composition will cause the premium to rise, inducing the exit of even more low-risk applicants. Eventually the market will have a

⁶⁹ MAS-COLELL ET AL., *supra* note 66, at 483 (“[I]ncentives for high effort can be provided only at the cost of having the manager face risk.”).

⁷⁰ To be precise, the degree to which the optimal contract deviates from full insurance is based on two factors: (1) how much the agent's actions influence the probability of the uncertain outcomes, and (2) the extent of the agent's risk aversion. As the first factor increases, the benefit to imposing risk on the agent increases. Imposing risk, however, is costly for the risk-averse agent. The second factor measures the extent of this cost. The optimal deviation from full insurance considers both the costs and benefits of imposing risk on the agent. Holmström, *supra* note 68, at 79.

⁷¹ I restrict attention to two types of applicants for the purpose of explaining adverse selection. For a model with many types distributed along some interval, see MAS-COLELL ET AL., *supra* note 66, at 437-43.

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tendency to unravel, leaving only high-risk applicants in the pool. Because of asymmetric information, the insurer cannot match the premium to the individual's specific risk level. As a consequence, the low-risk applicants are driven from the market.⁷² This result is inefficient because the low-risk applicant wants to purchase insurance but will not because the premium is too high.

In summary, two guiding principles come from this economic analysis. First, when the agent's unobservable actions influence the probability of the uncertain outcome, the optimal contract does not fully insure the agent. Instead, the contract places some of the risk on the agent to encourage her to engage in risk-reducing activities. Second, the proper insurance premium should reflect the inherent risk the agent presents—low-risk applicants should (and usually do) pay less for insurance than high-risk applicants. If asymmetric information prevents such price discrimination, the market will have a tendency to unravel, leaving only high-risk applicants in the insurance pool.

B. Asymmetric Information and Mandatory Arbitration

To apply the framework, consider the following two-stage example. First, the employee suffers discrimination or perceives that she has been the victim of discrimination and this event leads to a claim. Second, if a claim arises, the dispute goes to arbitration or litigation, depending on the terms of the employment contract.

Again, assume two possible states of nature: bad and good. In the bad state, the employee files a claim—she either suffers an injury or perceives she has suffered an injury. In the good state, the employee does not file a claim. Naturally, the employee's perceptions about discrimination and her choice of whether or not to file suit will depend on the employer's actions. I will return to this point later. For now, make the untenable assumption that the employer's activities do not influence which of the two states occurs.

In litigation, once the employee files suit, the employer's payout might consist of attorney's fees, a punitive damages award, or a class-action lawsuit—all three leading to a large settlement or

⁷² This is an example of the so-called "lemons" problem. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90, 492-94 (1970).

trial expense.⁷³ In short, the employer faces a large payout if a discrimination dispute is resolved through litigation.⁷⁴

Three attributes prevent similar costs in arbitration. First, arbitrators rarely award punitive damages.⁷⁵ Second, the conventional wisdom is that attorney's fees in arbitration are cheaper than attorney's fees in litigation.⁷⁶ Third, generally speaking, arbitration does not allow for class actions.⁷⁷

These structural differences between arbitration and litigation clarify the risk-management benefits of arbitration. Arbitration reduces the employer's payout if the employee suffers discrimi-

⁷³ See Estreicher, *Rickshaws*, *supra* note 4, at 563 (stating that, for high-salaried employees, "the sheer costs of defending a litigation and the risks of a jury trial create considerable settlement value irrespective of the substantive merits of the underlying claim"); see also 42 U.S.C. § 1981a(a)(1), (b)(1)-(4) (1994) (providing for punitive damages in the case of intentional discrimination, but capping both punitive and compensatory damages based on the size of the employer, as measured by the number of employees).

⁷⁴ This part argues that the expected payout in arbitration is lower than the expected payout in litigation. This might be true for a certain class of employers only—high-risk employers. Part III.D.2. considers the difference between low-risk and high-risk employers.

⁷⁵ Reilly, *supra* note 2, at 1212; see Stipanowich, *supra* note 5, at 17 § nn.91-92 (noting studies from the securities area that found punitive damages were awarded in approximately 2.0% of all surveyed arbitration cases).

⁷⁶ See Estreicher, *Rickshaws*, *supra* note 4, at 564 n.14; Douglas Yarn, *Foreward: An Introduction to Ethics in a World of Mandatory Arbitration*, 18 GA. ST. U. L. REV. 903, 904 (2002) (stating that arbitration "has many advantages—speed and cost savings over litigation being touted as two of the primary ones"). Note, however, that Deborah Hensler has questioned the conventional wisdom regarding the relative costs and benefits of court-annexed arbitration. She finds that the "savings in lawyer time are often modest and not necessarily passed on to litigants through lower legal fees." Deborah R. Hensler, *A Glass Half Full, a Glass Half Empty: The Use of Alternative Dispute Resolution in Mass Personal Injury Litigation*, 73 TEX. L. REV. 1587, 1593 (1995). For most of this Article, I follow the conventional wisdom and assume that the attorney's fees in arbitration are lower than attorney's fees in litigation. But see Menkel-Meadow, *supra* note 12, at 58 ("We have little empirical verification of the claims made both for and against arbitration and ADR, including positive assertions made about reduced cost, speed, and access to dispute mechanisms.").

⁷⁷ See Reilly, *supra* note 2, at 1211. Notably, some states have started to recognize class-wide arbitration proceedings. See, e.g., Robert Jason Herndon, *Mistaken Interpretation: The American Arbitration Association, Green Tree Financial Corporation v. Bazzle, and the Real State of Class-Action Arbitration in North Carolina*, 82 N.C. L. REV. 2128, 2129 (2004) (discussing "both the policy arguments and legal bases supporting a decision by North Carolina to follow South Carolina to allow class-action arbitration when a contract is silent on the issue"). Last term, the Supreme Court ruled that the arbitrator should decide whether an arbitration provision forbids arbitration class actions. See *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444, 452-53 (2003). Despite this creep in class action arbitration, the prevailing wisdom is that class actions are less available in arbitration than litigation.

nation and files suit. By eliminating the chance of a large jury verdict or class-action lawsuit, mandatory arbitration insulates the employer from some of the risk that flows from the filing of discrimination claims.⁷⁸

C. *Accounting for Moral Hazard*

Mandatory arbitration does not fully insulate the employer from paying for discriminatory conduct in the workplace. Instead, the employee and the employer share the risk. This makes sense. The employer's actions influence whether there is discrimination or the perception of discrimination in the workplace. Moral hazard remains a possibility. Therefore, the optimal "risk-sharing" arrangement places some risk on the employer.

Mandatory arbitration accomplishes this goal. Because arbitrators rule on the merits, the employer will pay more if a claim is filed. The employer bears some of the risk associated with its actions. This risk-bearing gives the employer an incentive to engage in preventive measures. This incentive flows from the employer's desire to reduce the employee's chance of prevailing in arbitration, as well as to reduce the extent of the possible award. Nevertheless, because of arbitrators' reluctance to render large awards and the elimination of class actions, the employer does not bear the same amount of risk in arbitration as it does in litigation. In theory, mandatory arbitration accounts for the trade-off between insurance and incentives. Through mandatory arbitration, an employer avoids the large payouts resulting from the randomness of the discriminatory activities of its agents and discrimination perceptions generally. At the same time, mandatory arbitration maintains the employer's incentive to monitor, select, and train its employees.

D. *Repeat Players, Wage Effects, and Relevant Evidence*

Marc Galanter has argued that repeat players in the legal system have a systematic advantage over "one-shot" players.⁷⁹ Galanter identified a number of reasons for this advantage. First, repeat players have "advance intelligence," enabling them to

⁷⁸ Accord Stephen J. Ware, *Arbitration under Assault: Trial Lawyers Lead the Charge*, Cato Policy Analysis No. 433, at 9 (Apr. 18, 2002), at <http://www.cato.org/pubs/pas/pa-433es.html> (last visited Feb. 15, 2005) (noting that through arbitration, "the business gets lower process costs and, perhaps, reduced exposure to big-dollar jury awards and class actions").

⁷⁹ See Galanter, *supra* note 12.

structure transactions appropriately to anticipate legal action.⁸⁰ Second, the repeat player has access to specialists, enjoys economies of scale, and benefits from “low start-up costs for any case.”⁸¹ Third, the repeat player has “opportunities to develop facilitative informal relations with institutional incumbents.”⁸² Fourth, a repeat player must maintain credibility and reputation in bargaining. This credibility makes it easier for the repeat player to commit to a bargaining position.⁸³ Fifth, a repeat player can “play the odds” and “adopt strategies calculated to maximize gain over a long series of cases, even where this [strategy] involves . . . maximum loss in some cases.”⁸⁴ Sixth, the repeat player has an incentive to shape the law in her favor through expenditures such as lobbying.⁸⁵ Seventh, the repeat player has an incentive to litigate, as opposed to settle, “cases which [he or she regards] as most likely to produce favorable rules.”⁸⁶

Using Galanter’s framework, some scholars maintain that employers enjoy a systematic advantage over employees in arbitration. These scholars contend that arbitration tends to favor employers because employers are repeat players at arbitration whereas employees are not.⁸⁷ In fact, some critics of mandatory arbitration argue that employers impose arbitration as a condition of employment to secure this repeat-player advantage.⁸⁸

A risk-based analysis offers a different take on the “repeat player” effect. The fact that employees have alleged discrimination claims against the employer in the past reveals something about the unobservable characteristics of that employer’s workplace, namely, the discriminatory tendencies of the employer’s agents. This information can be used to construct an employer’s “risk profile.” The employer’s risk profile represents a prediction about the likelihood of future discrimination claims against that employer. This risk profile is what determines the benefits of mandatory arbitration. The more likely an employer is to face

⁸⁰ *Id.* at 98.

⁸¹ *Id.*

⁸² *Id.* at 98-99.

⁸³ *Id.*

⁸⁴ *Id.* at 99-100.

⁸⁵ *Id.* at 100.

⁸⁶ *Id.* at 101.

⁸⁷ See Schwartz, *supra* note 2, at 60-61; Bingham, *supra* note 12, at 231 (noting that the EEOC maintains that “mandatory arbitration has a built-in bias for the employer who is a repeat player”).

⁸⁸ See Sternlight, *Panacea*, *supra* note 2, at 684-85.

discrimination claims, the greater the benefits of mandatory arbitration.

To make the point, consider the liability insurance market for discrimination claims. In this market, insurance contracts require that employers reveal their discrimination history as a pre-condition to coverage.⁸⁹ The premium is based on this history, with repeat discriminators (like accident-prone drivers) paying higher premiums. Insurance carriers, at least, believe that an employer's discrimination history is an important predictor of future discrimination claims. The link between liability insurance contracts and mandatory arbitration yields the insight that the repeat discriminator gains more than the one-time discriminator from the risk-management benefits that mandatory arbitration offers. The reason is that the repeat discriminator, as a statistical matter, is more likely to face another claim, including a claim that carries with it the chance of punitive damages.

The next step is to ask whether the cost of mandatory arbitration, like the cost of liability insurance, corresponds to the discrimination risk profile of the employer. In other words, does the high-risk employer actually pay more to use mandatory arbitration? If not, the market will have a tendency to separate. In addressing the cost question, I first consider the impact of mandatory arbitration on wages.

1. *Wage Effects*

Although the idea is controversial, some scholars argue that wages respond to the presence or absence of an arbitration clause in an employment contract.⁹⁰ In other words, through higher wages, the employer compensates the employee for selling labor *and* agreeing to bear the risk of discrimination or the perception of discrimination. Yet, to avoid the unraveling of the market, the wage payment must match the specific risk presented by the employer.⁹¹ Analogous to the increased premiums paid for liability insurance, the high-risk or repeat discriminator should pay more for the benefits of mandatory arbitration. Re-

⁸⁹ See, e.g., Kemper, *Employment Practice Liability Insurance Application* (on file with author); Peterson International Underwriters, *Application for Employment Practices Liability Insurance with Third Party Discrimination Coverage*, available at <http://www.piu.org> (last visited Dec. 20, 2004).

⁹⁰ See Hylton, *supra* note 4, at 224-26.

⁹¹ *Infra* note 107 and accompanying text provides a complete description of the negative effects of an unraveling market.

quiring that employers reveal their discrimination history before the employee is bound by the employment contract should help to achieve this result.⁹²

Revelation of the discrimination history is not enough, however. The wage demand must also respond to (1) the presence or absence of an arbitration provision and (2) the employer's discrimination history. However, the notion that employees are compensated for agreeing to mandatory arbitration is not universally accepted. Many scholars argue that wages are not sensitive to the inclusion of an arbitration clause because "an employee can only attempt to gain [wage] concessions if he fully appreciates the disadvantages or costs arising from the non-negotiable portions of the agreement [i.e., the arbitration clause]."⁹³ The rational employee, however, will not invest time and resources reading the proposed employment agreement.⁹⁴ The expected cost of reading the complete agreement is likely to outweigh the expected benefits, especially if the arbitration clause concerns unlikely consequences and "appear[s] in small print and/or [is] defined using obscure language."⁹⁵ Because the employee will not likely read, appreciate, or understand the arbitration provision, the employer that includes an arbitration provision in an employment contract most likely can avoid having to pay higher wages.⁹⁶

The counter to this argument is to craft a market response—the emergence of an entrepreneurial firm offering an employ-

⁹² The counter-argument to this proposal follows: If the wage contains an implicit premium, those employers with no discrimination history will have an incentive to reveal that information to the employee in order to pay a lower premium and, consequently, a lower wage. The market will have a tendency to separate itself. Repeat discriminators that employ mandatory arbitration provisions will pay higher wages than non-repeat discriminators that employ mandatory arbitration provisions. The lack of a discrimination history works like a warranty, signaling, in effect, the quality of the workplace.

This market solution might not work. The employer that reveals its discrimination history, or lack thereof, might actually encourage claims by alerting employees to their rights. This possibility imposes a cost on firms that attempt to signal "quality" through the revelation of a favorable discrimination history. A requirement that all employers reveal their discrimination history solves this problem. With this requirement, all workers, not just workers of signaling firms, are alerted to their rights.

⁹³ Cole, *supra* note 2, at 475.

⁹⁴ Cole, *supra* note 2, at 475; Schwartz, *supra* note 2, at 57 (noting the adherent is "unlikely to undertake the time and expense to research the implications of an arbitration clause or obtain legal advice").

⁹⁵ Cole, *supra* note 2, at 475.

⁹⁶ See *id.* at 475-76.

ment contract without an arbitration provision.⁹⁷ Because the entrepreneurial firm forgoes the benefits of mandatory arbitration, that firm should be able to offer lower wages and still attract workers. Responding to this proposal, scholars retreat from the rational actor model and assert that employees suffer from some sort of cognitive bias.⁹⁸ As a consequence of this supposed bias, employees are not likely to properly value and assess the risk of a lawsuit.⁹⁹ Employees, therefore, “settle for lower wages and benefits than they would demand if they fully understood the risks of arbitration as compared to litigation.”¹⁰⁰

If cognitive errors and biases limit the ability of employees to price the premium for the benefits that mandatory arbitration offers, one possible conclusion is to outlaw mandatory arbitration altogether. Indeed, some critics of mandatory arbitration take this position because they believe that the wage demand is not responsive.¹⁰¹ But this conclusion is premature. With no wage effect, mandatory arbitration appears to benefit the employer at the employee’s expense. If this is true, the puzzle identified in the introduction returns: Why does not every employment contract include a mandatory arbitration provision?¹⁰² The next sub-

⁹⁷ See *id.* at 479-80. Hylton, *supra* note 4, at 252-53, offers a related market response to the uninformed employee, suggesting that “a competing firm [could] gain by informing the applicant of the risks and offering a superior arrangement.”

⁹⁸ A retreat from the rational actor model is not necessary. Avery Katz has demonstrated that “[i]f buyers fail to read the fine print, sellers writing standardized [contracts] have [an] incentive to choose the quality level as low as possible.” Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 287 (1990). By the same reasoning, the employer that inserts a mandatory arbitration provision in fine print need not fear a demand for higher wages if the applicant is unlikely to read the arbitration provision.

⁹⁹ Cole, *supra* note 2, at 480-82; Schwartz, *supra* note 2, at 57 (“In her ignorant position, the adherent is most likely to undervalue the right to a judicial forum.”).

¹⁰⁰ Cole, *supra* note 2, at 481.

¹⁰¹ See Schwartz, *supra* note 2, at 116.

¹⁰² In raising this question, I rely on the fact that the Supreme Court legitimized the use of mandatory arbitration in 1991, the year it decided *Gilmer*. In 1992, about ten percent of employers used mandatory dispute resolution and an additional eight percent were considering the idea. HEALTH, EDUC., AND HUMAN SERVS. DIV., U.S. GEN. ACCOUNTING OFFICE, EMPLOYMENT DISCRIMINATION: MOST PRIVATE SECTOR EMPLOYERS USE ALTERNATIVE DISPUTE RESOLUTION 7 & n.10, 8 (July 1995). In 1997, the GAO reported that nineteen percent of employers use arbitration. U.S. GEN. ACCOUNTING OFFICE, ALTERNATIVE DISPUTE RESOLUTION: EMPLOYERS’ EXPERIENCE WITH ADR IN THE WORKPLACE, Letter Report, 2 (1997). The 1995 and 1997 GAO studies represent the latest and best evidence available on the use of arbitration. In 2002, the Court in *Circuit City*, at least indirectly, resolved any uncertainty about the scope of *Gilmer*. We do not have figures on how many employers

section considers this puzzle in some detail, assuming first that wages adjust and then analyzing the puzzle if wages do not adjust.

2. Relevant Evidence

To avoid adverse selection, the expected award and/or wages need to fluctuate with the *ex ante* risk presented by the specific employer. In practice, we know that neither the award nor wages adjusts to the employer's risk profile. Without this adjustment, the market will have a tendency to unravel. The employers that gain the most from the risk management benefits of mandatory arbitration—the repeat discriminators—will use mandatory arbitration. Other employers will litigate because the total cost of mandatory arbitration (wage premiums plus the expected award) does not reflect their specific risk level.¹⁰³ Restated, the one-time discriminator resolves its disputes in litigation, while the serial discriminator resolves its disputes in arbitration.

This market segmentation provides an alternative explanation for the puzzling outcomes of discrimination litigation. As an empirical matter, a substantial fraction of discrimination claims that are litigated end in summary judgment for the employer.¹⁰⁴

use mandatory arbitration today. Arguably, *Circuit City* rather than *Gilmer* represents the watershed moment in the legitimization of mandatory arbitration. My results do not turn on the exact number of employers using mandatory arbitration so long as some employers use mandatory arbitration and others do not. This is a reasonable assumption given that discrimination cases continue to fill the federal docket.

¹⁰³ See Hylton, *supra* note 4, at 240 (making a similar adverse selection argument when the applicant does not know the employer's type: high-risk or low-risk).

¹⁰⁴ Stewart Schwab has thoroughly analyzed the discrimination case outcomes. Stewart J. Schwab, *How Employment Discrimination Cases Fare in the Federal Courts: An Empirical Analysis* at 3 (May 19, 2001) (report filed in the fairness hearing for *Ingram v. The Coca-Cola Co.*, 200 F.R.D. 685 (N.D. Ga. 2001)) (on file with author). According to Schwab, "16 percent of all employment discrimination cases are resolved by pretrial motion." Of the cases resolved by pretrial motion, defendants prevail 96 percent of the time. Schwab compares this pretrial win rate to other kinds of cases, finding that across all cases plaintiffs win 19 percent of the pretrial motions. Schwab concludes that "[a]t every stage of litigation, plaintiffs have a more difficult time in employment discrimination cases than in virtually any other category of cases." *Id.* at 1. Schwab analyzed data from 1970-1997. *Id.* Schwab's sample is too large for my purposes, including case outcomes from before the emergence of mandatory arbitration.

To solve this problem, I replicated Schwab's results, restricting attention to the time period when mandatory arbitration was available. If my thesis is correct, one should observe an increase in the summary judgment numbers favoring employers as more high-risk employers opt out of litigation into arbitration. As a starting date

Scholars suggest that this occurs because federal judges exhibit a bias against plaintiffs in discrimination cases and are therefore willing to grant employers summary judgment despite the existence of legitimate questions of fact.¹⁰⁵

According to the market segmentation argument, the summary judgment numbers reflect the fact that the employers most likely to lose on summary judgment—the repeat discriminators—have opted out of litigation and are now using arbitration to resolve disputes. This analysis generates an interesting insight. Even if the incidence of discrimination has not decreased over the last ten years, there would still be an increase in the percentage of employers winning on summary judgment as a result of high-risk employers' insuring themselves through arbitration, leaving only the low-risk employers to the tools of litigation and summary judgment.¹⁰⁶ Conversely, for this same reason, a higher percent-

for my sample, I use 1991, the year in which the Supreme Court decided *Gilmer*. Between 1991 and 2000, employers prevailed in ninety-seven percent of the pretrial motions. The data exhibit a rough upward trend. In 1991, employers prevailed in ninety-five percent of the pretrial motions. In 2000, employers prevailed in ninety-eight percent of the pretrial motions. These data are at least consistent with my thesis, although the increase in the employer win-rate is admittedly small. (data and results on file with author). Perhaps, more important is my claim that the win-rates for employers should continue to increase over time. This is a prediction of the model, which can be tested as data become available. The data for this truncated study came from the Administrative Office dataset, the same dataset used by Schwab. The data is available at <http://teddy.law.cornell.edu:8090/questtr2.htm> (last visited Feb. 15, 2005).

¹⁰⁵ See Theresa M. Beiner, *The Misuse of Summary Judgment in Hostile Environment Cases*, 34 WAKE FOREST L. REV. 71, 73 (1999); Judith Olans Brown et al., *Some Thoughts About Social Perception and Employment Discrimination Law: A Modest Proposal for Reopening the Judicial Dialogue*, 46 EMORY L.J. 1487, 1490 (1997); Laura Gatland, *Courts Behaving Badly: Task Forces Say Some Judges Impatient with Job Bias Cases*, 83 A.B.A. J. 30 (1997); Ann C. McGinley, *Credulous Courts and the Tortured Trilogy: The Improper Use of Summary Judgment in Title VII and ADEA Cases*, 34 B.C. L. REV. 203, 236 (1993); M. Isabel Medina, *A Matter of Fact: Hostile Environments and Summary Judgments*, 8 S. CAL. REV. L. & WOMEN'S STUD. 311, 314-15 (1999); Leland Ware, *Inferring Intent from Proof of Pretext: Resolving the Summary Judgment Confusion in Employment Discrimination Cases Alleging Disparate Treatment*, 4 EMPLOYEE RTS. & EMP. POL'Y J. 37, 68 (2000).

¹⁰⁶ Low-risk employers are more likely to prevail on summary judgment because, almost by definition, a claim against a low-risk employer is more likely to be the result of a heightened proclivity to file suit rather than actionable discrimination.

This theory assumes that the win-rates on summary judgment are indicative of the merits of the pool of cases being litigated. This assumption ignores the possibility of settlement. Suppose, for example, that both the employer and the employee know that discrimination cases in litigation are usually against low-risk employers. With this knowledge, the employer has the incentive to offer a low settlement, which the plaintiff will accept, rather than take the chance of losing on summary judgment.

age of arbitration cases should be resolved in favor of employees.¹⁰⁷

For scholars and policymakers concerned about the impact of arbitration on the evolution of the law, this theory—if tested and verified—is perhaps disconcerting.¹⁰⁸ Under this argument, the law is based on cases against low-risk employers, not high-risk employers. And, for this reason, the law might evolve in favor of employers.

Note, too, that the market segmentation idea does not hinge on the assumption that the employee who agrees to mandatory arbitration receives a higher wage. As many have conjectured, wages may not respond at all to the presence of the arbitration provision. The above analysis presupposes that the employer's expected payout is less in arbitration than in litigation. For two reasons, however, this might not be true for every employer. First, arbitration usually does not offer the opportunity for sum-

To make sense of market segmentation, the win-rates must be linked to the pool of cases, paying attention to the possibility of settlement.

To do this, I rely on some results derived by Lucian Bebchuk. Lucian Arye Bebchuk, *Litigation and Settlement under Imperfect Information*, 15 RAND. J. ECON. 404, 406-09 (1984). Bebchuk models settlement as a game between a defendant with private information and a plaintiff. The defendant's private information is the plaintiff's chance of prevailing in litigation, which lies in the interval, d and ∂ and is distributed according to the cumulative distribution function, $F(d)$. The plaintiff makes the offer, which the defendant accepts or rejects. Bebchuk shows that when the interval shifts up or down the chance of settlement remains the same. *Id.* at 410-11. This means the chance of litigation remains the same, too. In this settlement game, the win-rates broadly reflect the merits (i.e., the interval, $[d, \partial]$ of the underlying pool of cases litigated. This is, of course, one of many ways to model settlement. The settlement literature is vast and I do not discuss it all in this Article. Here, however, the Bebchuk model makes some sense because the employer in a discrimination case is apt to have private information bearing on the case (i.e., firm data and records that are not easy to discover).

¹⁰⁷ The available empirical evidence supports this finding. See Maltby, *supra* note 4, at 46 (finding that “employees prevail more often in arbitration than in court”); see also Michael Delikat & Morris M. Kleiner, *An Empirical Study of Dispute Resolution Mechanisms: Where Do Plaintiffs Better Vindicate Their Rights?*, 58 DISP. RES. J. 56, 58 (Nov. 2003/Jan. 2004) (finding estimates showing that “[a]fter taking into account legal fees, the plaintiffs receive more on average with arbitration”); Theodore Eisenberg & Elizabeth Hill, *Arbitration and Litigation of Employment Claims: An Empirical Comparison*, 58 DISP. RES. J. 44, 48, at Table 1 (Nov. 2003/Jan. 2004) (finding that higher paid employees prevail more often in the arbitration of civil rights claims than the litigation of employment discrimination claims in federal court (although this difference is statistically insignificant)).

¹⁰⁸ A researcher might test this theory by comparing the discrimination history of employers that use mandatory arbitration with the discrimination history of employers that litigate. I leave this empirical inquiry to future research.

mary judgment.¹⁰⁹ Second, at least in some states, the employer must front the arbitration fees to render the mandatory arbitration clause enforceable.¹¹⁰ Intuitively, then, the low-risk employer might opt for litigation in order to avoid the risk of resolving a discrimination claim in a forum with arbitration fees and without summary judgment. In contrast, the high-risk employer might opt for arbitration to avoid the possibility of a jury trial and a punitive damage award (risks that the high-risk employer is particularly concerned about). Not surprisingly, in deciding whether to use mandatory arbitration, the employer compares the expected costs of arbitrating and litigating a discrimination dispute. In short, arbitration might not offer any benefit to the low-risk employer because the payout in arbitration is actually greater than the litigation payout.¹¹¹

To solve the market segmentation problem, I suggest that arbitrators consider the employer's discrimination history in fashioning the arbitration award.¹¹² After a finding of liability, the

¹⁰⁹ See Maureen A. Weston, *Checks on Participant Conduct in Compulsory ADR: Reconciling the Tension in the Need for Good-Faith Participation, Autonomy, and Confidentiality*, 76 IND. L.J. 591, 593-97 (2001) (noting that in arbitration "[t]he rules of evidence generally do not apply, discovery and motions practices are not used").

¹¹⁰ *Ferguson v. Countrywide Credit Indus., Inc.*, 298 F.3d 778, 785-86 (9th Cir. 2002); *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 894 (9th Cir. 2002); *Cole v. Burns Int'l Sec. Servs.*, 105 F.3d 1465, 1484-86 (D.C. Cir. 1997); *Paladino v. Avnet Computer Techs., Inc.*, 134 F.3d 1054, 1062 (11th Cir. 1998) (Cox, J., concurring).

¹¹¹ Deborah Hensler's work questioning the cost-effectiveness of arbitration buttresses this conclusion. See Hensler, *supra* note 76. In terms of expected payout, including attorney's fees and claim frequency, for some employers arbitration might not be cheaper than litigation.

Strictly speaking, if there is no wage adjustment, there is no adverse selection. Instead, employers simply self-select into the cheapest forum for dispute resolution. Because the arbitration clause does not affect the wage, the fact that bad employers opt out of the litigation system does not impact the "price" (in terms of increased wages) good employers pay for using arbitration—the central feature of adverse selection. I am agnostic about whether wages adjust. My point here is to show that the same market segmentation can occur, with or without a wage adjustment.

¹¹² Under this approach, large employers are apt to suffer more claims and, as a result, face a greater chance of a ratcheted award. This is easy to fix by ratcheting based on the "rate" of claims, rather than the number of claims. A rate approach controls for company size. Such approaches, so-called "experience rating," are common. For example, state governments use experience rating to compute the amount of money an employer must pay into the unemployment insurance fund. Controlling for company size, the more likely the firm is to have layoffs, the more the company must pay into the unemployment insurance pool. See Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 388-89 (2002/2003) (explaining the use of experience rating for unemployment insurance and stating that "[e]xperience rating is the insurance term for charging different prices based on past experience. It is a form of risk classification

employer's discrimination history should serve as a ratchet, increasing the arbitration award for the discrimination-prone employer and decreasing the award for the one-time discriminator.¹¹³

The enforcement of this proposal is possible even if individual arbitrators are reluctant to adopt the practice.¹¹⁴ The proposal could be incorporated into the *Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising Out of the Employment Relationship*.¹¹⁵ Responding to *Gilmer*, this Protocol represented an effort by the American Arbitration Association (AAA) and the Judicial Arbitration and Mediation Services (JAMS) to address the fairness problems associated with the mandatory arbitration of discrimination disputes.¹¹⁶ The AAA and JAMS are two major providers of arbitration services. Both of these organizations refuse to provide arbitration services unless the parties agree to the Protocol.¹¹⁷ The Protocol therefore influences the way in which many arbitration proceedings are conducted.

E. Using Risk-Management in the Adequacy-Based and Contract-Based Exceptions

A risk-based analysis informs the adequacy-based and contract-based exceptions to the enforcement of mandatory arbitra-

because past experience is used to predict future risk. So, for example, an employer that has laid off significant numbers of workers in the past is treated as a higher risk for layoffs in the future and, accordingly, is charged a higher rate").

¹¹³ Under the ratchet system, the savvy employee might wait to file, knowing that the last employee to successfully file reaps the largest award. Allocating part of the ratcheted award to employees who have filed in the past alleviates this problem.

The ratchet system proposed is not unheard of for corporate penalties. The Federal Sentencing Guidelines, for example, consider the employer's past history at sentencing. See U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(c) (2004).

¹¹⁴ Individual arbitrators might be wary of adopting this practice because it harms the repeat discriminator—a valuable source of business for the individual arbitrator. On the other hand, this practice makes arbitration attractive to low-risk employers, increasing the volume of business. It is hard to say which effect would dominate. As a result, it is not clear that individual arbitrators would necessarily be opposed to the ratchet system proposed here.

¹¹⁵ Due Process Protocol for Mediation of Statutory Disputes Arising out of the Employment Relationship, BNA DAILY REPORT, at A-8, E-11 (May 11, 1995); see also Sarah Rudolph Cole, *Uniform Arbitration: "One Size Fits All" Does Not Fit*, 16 OHIO ST. J. ON DISP. RESOL. 759, 775-77 (2001) (describing the Due Process Protocol).

¹¹⁶ Cole, *supra* note 116.

¹¹⁷ *Id.* at 776

tion provisions in employment contracts. As discussed, under the adequacy-based exception, the employee may avoid arbitration by showing that her statutory rights cannot be vindicated in the arbitral forum.¹¹⁸ The employee must show that arbitration is not a substitute forum, but rather no forum at all. Under the contract-based exception, the employee may seek revocation on generally applicable state law grounds such as duress, fraud, or unconscionability.¹¹⁹

1. *The Adequacy-Based Exception*

The adequacy-based exception has a clear analog within the new framework. If the arbitral forum is inadequate, the employer pays the same in both good and bad states; that is, the employee will not file suit, whether or not she suffers or perceives she suffers discrimination. It is not worth the employee's effort to file in an inadequate arbitral forum. Knowing that a claim is unlikely, the employer will not take steps to mitigate the chance of discrimination perceptions. In particular, the employer will not try to control the discriminatory activities of its agents. With an inadequate arbitral forum the employer no longer bears *any* risk associated with its activities. The threat of dispute resolution in arbitration ceases to function as a deterrent.

The inadequate arbitral forum is a variation of the classic waiver argument. The inadequate arbitral forum allows the employer to turn a blind eye to the discriminatory activities of its agents and to ignore the possibility of discrimination perceptions by the employee. In effect, the applicant who agrees to an inadequate arbitral forum waives her right to have the employer attempt to control the discriminatory activities of its agents.

With an inadequate forum, the employee bears all the risk of discriminatory activities by other agents of the employer. Note, here, the risk of discrimination does not go away with an inadequate forum; it shifts from the employer to the employee.¹²⁰ This

¹¹⁸ See *supra* note 36 and accompanying text.

¹¹⁹ See *supra* note 35 and accompanying text.

¹²⁰ It is for this reason that I model arbitration as risk management as opposed to risk reduction. It is easiest to see the "management" angle in the case of a waiver of a right to bring a discrimination claim. The underlying random event is the discriminatory conduct of the employer's agents, which causes injury. Assume the harm takes place; the question, then, is who pays. If the employee waives her right to sue (accepts an inadequate arbitral forum), the employee absorbs the injury. The injury still takes place, but the employer has shifted the risk to the employee. From the employer's standpoint, the risk is reduced. But the harm caused by the underlying

risk bearing is costly for the risk-averse employee, especially because she cannot mitigate its effects by diversifying away the chance of discrimination or buying insurance for discrimination injuries through the market.¹²¹ And, it is for this reason only, I would argue, that an agreement to arbitrate in an inadequate forum is problematic.

2. Unconscionability

Turning to the other exception, the most popular “contract-based” challenge is unconscionability. As a legal concept, unconscionability is imprecise. A suitable working definition comes from *Williams v. Walker-Thomas Furniture Co.*: “Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”¹²² Following this language, scholars have divided unconscionability into two components: procedural and substantive.¹²³ Procedural unconscionability refers to defects in the bargaining process that result in an “absence of meaningful choice,” broadly defined to include the use of fine print, convoluted language, and an inequality of bargaining power.¹²⁴ Substantive unconscionability refers to the reasonableness or fairness of the resulting bargain.¹²⁵ Although analytically distinct, courts usually require a combination of procedural and substantive unconscionability before striking down a contract as unconscionable. Generally speaking, the greater the amount of procedural unconscionability, the less substantive unconscionability is needed to invalidate the contract.¹²⁶

random event still occurs. Holding constant any incentive effects, the way I think of it is as follows: As the arbitration clause becomes more and more favorable to the employee, the employer bears more of the risk (pays for a higher fraction of the injury) and the employee pays less. In the limit—no arbitration, just litigation—the employer bears all the risk of discriminatory conduct by its employees and discrimination perceptions more generally. Alternatively, one could, I suppose, model arbitration as a form of risk reduction.

¹²¹ Of course, if the wage is adjusted appropriately (including compensation for bearing the risk of discrimination), the employee might be better off agreeing to an inadequate arbitral forum. See Hylton, *supra* note 4, at 262. As noted, my position does not rely on wage adjusting in response to an arbitration provision.

¹²² 350 F.2d 445, 449 (D.C. Cir. 1965).

¹²³ E. ALLAN FARNSWORTH, *CONTRACTS* 311 (3d ed. 1999).

¹²⁴ *Id.* at 311-12.

¹²⁵ *Id.*

¹²⁶ *Id.* at 312-13 (collecting cases).

Applying these principles, several state and federal courts have found a mandatory arbitration provision in an employment contract to be unconscionable.¹²⁷ Such findings are not universal, however, as several other courts have upheld arbitration provisions in the face of unconscionability challenges.¹²⁸ Furthermore, through *Gilmer* and *Circuit City*, the Supreme Court clarified that the mere inclusion of a mandatory arbitration provision in an employment contract is not unconscionable per se.¹²⁹ What then makes a mandatory arbitration provision unconscionable? How can a court distinguish a valid arbitration provision from an invalid arbitration provision?

The case law provides some clues to answering these questions. In the usual case of unconscionability, the court first declares that the employment contract is adhesive and therefore procedurally unconscionable.¹³⁰ The court reaches this result in two steps. First, the court asserts that the employee had to sign the arbitration provision as a condition of employment. Second, the court notes that the arbitration provision was non-negotiable.¹³¹

After finding the employment contract procedurally uncon-

¹²⁷ See *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 893-94 (9th Cir. 2002); *Ferguson v. Countrywide Credit Indus., Inc.*, 298 F.3d 778, 782-85 (9th Cir. 2002); *Cooper v. MRM Inv., Co.*, 199 F. Supp. 2d 771, 777-79 (M.D. Tenn. 2002); *Armendariz v. Found. Health Psychcare Servs.*, 6 P.3d 669, 689-94 (Cal. 2000) (discussing unconscionability under the rubric of “objections to arbitration that apply more generally to any type of arbitration imposed on the employee by the employer as a condition of employment, regardless of [whether that claim involved an unwaivable statutory right]”). The bulk of *Armendariz* deals with the “adequacy-based” exception.

¹²⁸ *Koveleskie v. SBC Capital Mkts., Inc.*, 167 F.3d 361, 366 (7th Cir. 1999); *Seus v. John Nuveen & Co., Inc.*, 146 F.3d 175, 177, 184 (3d Cir. 1998); *Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 170 F.3d 1, 16-17 (1st Cir. 1999) (rejecting the unconscionability argument, but refusing to enforce the arbitration agreement on other grounds); *Adkins v. Labor Ready, Inc.*, 303 F.3d 496, 498, 501-03 (4th Cir. 2002). Most of these cases involve arbitration provisions contained in U-4 forms—the securities registration form at issue in *Gilmer*. See *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 23 (1991). In all these cases, the employee had to sign the U-4 form and register with the various exchanges as a condition of employment. However, as previously discussed, the Supreme Court does not view the U-4 form as part of an employment contract. *Id.* at 25 n.2. Presumably, the circuits would apply the same unconscionability analysis if the employment contract contained the arbitration provision.

¹²⁹ See *Gilmer*, 500 U.S. at 32-33; *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 122-23 (2001).

¹³⁰ See *Ferguson*, 298 F.3d at 783-84; *Circuit City Stores, Inc.*, 279 F.3d at 893; *Armendariz*, 6 P.3d at 675, 689.

¹³¹ *Ferguson*, 298 F.3d at 783-84; *Circuit City Stores, Inc.*, 279 F.3d at 892-93; *Armendariz*, 6 P.3d at 675, 689.

scionable, the court reviews the contract terms for substantive unconscionability. In conducting this substantive analysis, courts have paid close attention to three factors. First, courts have considered the fee structure imposed by the agreement.¹³² In California, for instance, if the agreement requires that the employee pay any of the arbitration fees, the arbitration provision is deemed substantively unconscionable.¹³³ Second, courts have examined whether the agreement is asymmetric; that is, whether the employee must arbitrate his or her claims against the employer whereas the employer is allowed to choose between arbitration and litigation for its claims against the employee.¹³⁴ Finally, courts have considered the degree to which the agreement limits the scope of available relief and discovery.¹³⁵

A risk-based analysis moves the unconscionability inquiry in a different direction. An arbitration provision might be unconscionable because it fails to account for moral hazard and adverse selection. Courts could uncover such a failure by comparing the arbitration agreement to the liability insurance policies available in the market. Market insurance policies are unlikely to reflect unequal bargaining power or the lack of meaningful choice.¹³⁶ For example, suppose that every market insur-

¹³² *Ferguson*, 298 F.3d at 785; *Circuit City Stores, Inc.*, 279 F.3d at 894. Note that many courts have considered the fee structure under the adequacy-based exception rather than as part of an unconscionability analysis. See, e.g., *Cole v. Burns Int'l Sec. Servs.*, 105 F.3d 1465, 1485-87 (D.C. Cir. 1997); *Paladino v. Avnet Computer Techs.*, 134 F.3d 1054, 1062 (11th Cir. 1998).

Indeed, the adequacy exception and substantive unconscionability are not analytically distinct categories. The same elements that make an arbitral forum inadequate will tend to render the arbitration provision one-sided and therefore substantively unconscionable.

¹³³ *Ferguson*, 298 F.3d at 785 (citing *Circuit City Stores, Inc.* for the proposition that “a fee allocation scheme which requires the employee to split the arbitrator’s fees with the employer would alone render an arbitration agreement substantively unconscionable”).

¹³⁴ E.g., *Ferguson*, 298 F.3d at 784-85; *Circuit City Stores, Inc.*, 279 F.3d at 893-94; *Armendariz*, 6 P.3d at 691-92.

¹³⁵ E.g., *Ferguson*, 298 F.3d at 786-87; *Circuit City Stores, Inc.*, 279 F.3d at 893-94; *Armendariz*, 6 P.3d at 694 (noting that “the unconscionable one-sidedness of the arbitration agreement is compounded . . . by the fact that it does not permit the full recovery of damages for employees, while placing no such restriction on the employer”).

As with the fee structure, a number of courts have considered limitations on the scope of relief under the adequacy exception. *Cole*, 105 F.3d at 1482, 1485-86; *Paladino*, 134 F.3d at 1061-62.

¹³⁶ In the discrimination context, a market insurance policy reflects a deal between two companies—the insurance carrier and the employer.

ance contract requires that employers reveal their discrimination history as a pre-condition of coverage. In this example, a court might consider—as evidence of procedural unconscionability—that the employer did not reveal its discrimination history to the employee. On the other hand, as evidence of substantive unconscionability, the court might examine whether the arbitration procedure mimics market insurance by punishing repeat discriminators more harshly than one-time discriminators.

Admittedly, this approach to unconscionability has problems. A legal regime that forced arbitration procedures to mimic market insurance policies would be hard to administer. First, to apply a risk-management approach, courts would have to decide which of the many liability insurance contracts to consider. Even assuming that the court could choose a reference contract, a court would still have to decide whether the failure to match terms meant that the arbitration provision was unreasonably one-sided and therefore substantively unconscionable. In the run-of-the-mill unconscionability case, the party seeking to avoid the contract cannot prevail by simply showing that he or she entered into a bad bargain.¹³⁷

To summarize, the proposal in this subsection is narrow: that courts should consider the risk-management function of mandatory arbitration when conducting an unconscionability analysis.

F. Pre-Dispute Versus Post-Dispute Arbitration Agreements

In his essay on alternative dispute resolution, Steven Shavell lists several reasons why parties might agree to pre-dispute, mandatory arbitration.¹³⁸ These reasons include an improvement in *ex ante* incentives and a beneficial change in the frequency of disputes.¹³⁹ A risk analysis suggests another reason

¹³⁷ State *ex rel.* State Highway & Transp. Dep't v. Garley, 806 P.2d 32, 39 (N.M. 1991) ("The doctrine of unconscionability was intended to prevent oppression and unfair surprise, not to relieve a party of a bad bargain.") (quoting Drink, Inc. v. Martinez, 556 P.2d 348, 351 (N.M. 1976)); Frets v. Capitol Fed. Sav. & Loan Ass'n, 712 P.2d 1270, 1277 (Kan. 1986) (noting that unconscionability "is directed against one-sided, oppressive and unfairly surprising contracts, and not against the consequences *per se* of uneven bargaining power or even a simple old-fashioned bad bargain") (quoting Wille v. S.W. Bell Tel. Co., 549 P.2d 903, 907 (Kan. 1976)).

¹³⁸ Shavell, *supra* note 6, at 5-7. Shavell's analysis applies to mediation and abbreviated trial procedures as well as arbitration. The discussion here will focus on arbitration.

¹³⁹ *Id.* To illustrate the incentive argument, consider, as Shavell does, a case in

why employers might prefer mandatory arbitration. Through the mandatory arbitration agreement, the employer limits its exposure if a certain risk materializes. The employer cannot achieve the same benefit through a post-dispute arbitration agreement because, once the employee files the claim, it is too late. In the employment discrimination context, the post-dispute arbitration agreement is analogous to buying automobile accident insurance to cover an accident that had already taken place.

Responding to proponents who focus on the cost savings associated with arbitration, one critic asks, “[I]f binding arbitration were indeed as wonderful and fair as its advocates claim, why make it mandatory? Why not allow employees . . . to choose arbitration over litigation knowingly, after the dispute has arisen?”¹⁴⁰ Indeed, some scholars have suggested that employers might provide employees this choice.¹⁴¹ Such an option, however, destroys the risk management function of mandatory arbitration. It is not surprising that post-dispute arbitration agreements are relatively rare in employment discrimination cases. Few market insurance carriers agree to cover discrimination claims that have already been filed against the employer.¹⁴²

which the arbitrator has more expertise than the court. *Id.* at 5-6. As a result, the arbitrator can tell whether performance under the contract was substandard whereas the court cannot. In this situation, an *ex ante* agreement to arbitrate induces good performance, increasing the value of the contract to one or both parties. *Id.* at 6. This same benefit cannot be achieved through a post-dispute arbitration agreement because, when the parties agree to arbitrate, performance has already occurred. *Id.* at 6-7.

The argument about the frequency of suits is subtle. In the main, Shavell puts forth an example in which the frequency of suits does not alter the *ex ante* incentives of either party. *Id.* at 7. In this case, a high frequency of lawsuits reflects resources devoted to dispute resolution with little corresponding benefits in terms of incentives. Under these conditions, the parties are better off agreeing, *ex ante*, to reduce the frequency of suits. This is because the resources saved by avoiding frequent lawsuits can be split between the parties. The parties cannot achieve this same benefit through a post-dispute arbitration agreement because, *ex post*, one of the parties will want to litigate. Notably, Shavell’s frequency argument works in the other direction as well. *Id.* at 7 n.10. For example, parties might agree, *ex ante*, to use an arbitration procedure that results in more suits because the beneficial incentive effects outweigh the increase in dispute resolution costs. *Id.* at 7.

It is noteworthy that Shavell rejects the argument that parties agree to *ex ante* (mandatory) arbitration because arbitration is cheaper and less risky than litigation (in terms of, for instance, random jury verdicts). *Id.* at 5. Shavell argues that parties can achieve these same benefits through a post-dispute arbitration agreement. *Id.*

¹⁴⁰ Jean R. Sternlight, *Steps Need to Be Taken to Prevent Unfairness to Employees, Consumers*, DISP. RESOL. MAG., Fall 1998, at 7.

¹⁴¹ Cole, *supra* note 2, at 453-54.

¹⁴² *Supra* note 89.

Likewise, few employees agree to arbitrate after they have perceived discrimination and filed a claim.¹⁴³

Using a risk-based analysis to compare post-dispute and mandatory arbitration agreements offers one final insight. A post-dispute arbitration agreement does not create an incentive problem for the employer—there is no moral hazard. My conjecture is that it is for this reason that the most vocal critics of mandatory arbitration are nevertheless comfortable with post-dispute arbitration agreements.

IV

THE RELATIONSHIP BETWEEN MANDATORY ARBITRATION AND OTHER RISK-REDUCING MECHANISMS

Mandatory arbitration is one of many tools that employers can use to manage the risk of discrimination claims. As noted, employers can also purchase liability insurance through the market.¹⁴⁴ Moreover, employers can minimize the chance of lawsuits through strong in-house grievance procedures, diversity training, and the formulation and promulgation of non-discriminatory corporate policies. The interaction among these risk-management techniques provides fertile ground for empirical work.

Mandatory arbitration may function as a substitute for, or a complement to, liability insurance. Employers might choose to use mandatory arbitration as a substitute for three reasons. First, although widely available, liability insurance is expensive.¹⁴⁵

¹⁴³ Samuel Estreicher offers another explanation for the rarity of post-dispute agreements to arbitrate. Estreicher, *Rickshaw*, *supra* note 4. Estreicher suggests that it does not advance the employer's interest to agree to post-dispute arbitration when the employee fails to obtain counsel. *Id.* at 567. Instead, the employer has an incentive to let the case languish in the administrative agency. *Id.* On the other hand, if the employee does obtain counsel, it is unlikely that the employee's attorney will agree to arbitration, because arbitration reduces the settlement value of the case. *Id.* at 567-68. See also Drahozal, *supra* note 4, at 746-78 (arguing that "[transaction] costs are likely to be lower for parties entering into predispute arbitration agreements than those entering into postdispute arbitration agreements").

¹⁴⁴ On the desirability of liability insurance for discrimination disputes, see Joan Gabel et al., *Evolving Conflict Between Standards for Employment Discrimination Liability and the Delegation of that Liability: Does Employment Practices Liability Insurance Offer Appropriate Risk Transference?*, 4 U. PA. J. LAB. & EMP. L. 1 (2001).

¹⁴⁵ See Lorelie S. Masters, *Protection from the Storm: Insurance Coverage for Employment Liability*, 53 BUS. LAW. 1249, 1274 (1998) ("Although prices have come down as more insurance companies enter the EPLI [liability insurance] market, EPLI coverage still is fairly expensive.").

Second, when a discrimination claim arises, the parties often contest whether the claim falls within the coverage limits of the liability insurance policy.¹⁴⁶ Similar coverage disputes do not arise with mandatory arbitration, because the risk-management benefits of mandatory arbitration accrue no matter what kind of claim is asserted against the employer. Third, liability insurance policies usually cap the amount of payment on the policy and exclude coverage for punitive damages.¹⁴⁷ There are no similar restrictions with mandatory arbitration.

Despite this analysis, the conclusion that mandatory arbitration represents an inexpensive substitute for liability insurance is debatable. Mandatory arbitration and liability insurance might work in tandem. Depending on the terms, a liability insurance policy will cover the attorney's fees and the award from arbitration or litigation.¹⁴⁸ Presumably, then, the insurer will set the premium based in part on whether the employer uses mandatory arbitration.¹⁴⁹

As a matter of theory, both the complement story and the substitute story are plausible.¹⁵⁰ Without some empirical evidence, however, it is impossible to tell which story is true. Echoing a theme running throughout the Article, the risk-management vision of mandatory arbitration leads to new questions—namely, what is the exact relationship between liability insurance and mandatory arbitration? Do employers that use mandatory arbitration also purchase liability insurance through the market?

In practice, mandatory arbitration and liability insurance do

¹⁴⁶ The insurance policies often exclude “intentional” acts. *Id.* How this exclusion plays out in the context of any particular discrimination claim is hard to say. Mandatory arbitration contains no exclusions from coverage. Hence, from the employer's standpoint, mandatory arbitration might represent a better way to manage risk.

¹⁴⁷ *Id.* at 1273-74.

¹⁴⁸ Chaney, *supra* note 63, at 126 (“An EPLI [liability insurance] policy usually defines a claim as including any civil proceeding, administrative charge, or arbitration request arising out of an alleged covered employment practice.”).

¹⁴⁹ If mandatory arbitration is indeed cheaper than litigation for the employer, the liability insurance premium for an employer that uses mandatory arbitration should reflect this cost savings. Hence, holding all else constant, an inquiry into premiums provides a fruitful way to test the relative costs and benefits of arbitration and litigation.

¹⁵⁰ A brief online survey of EPLI insurance policies revealed that six out of fifty-one policies asked employers whether they used mandatory dispute resolution. This provides some preliminary support for the hypothesis that liability insurance and mandatory arbitration are substitutes. Clearly, a deeper empirical inquiry is needed before we can draw any conclusions with confidence.

the same thing: they allow employers to avoid paying the entire price of discrimination claims. Outlawing mandatory arbitration, in and of itself, would not force employers to bear the entire risk of the discriminatory activities of their agents, as is assumed by the critics of mandatory arbitration. This simple point demonstrates the mistakes that occur when analyzing mandatory arbitration in a vacuum. To avoid these mistakes, I suggest that scholars consider the interactions among the risk-management devices available to employers when making policy proposals regarding mandatory arbitration.¹⁵¹

CONCLUSION

The debate over mandatory arbitration is widespread and politicized in the public discourse, the courts, and the academy. Parties to this debate, however, have largely ignored the most important role of mandatory arbitration. Using the risk framework, this Article challenges much of the conventional wisdom about these provisions. In addition, this Article is designed as a springboard for empirical work. For example, scholars might examine whether repeat discriminators do worse in arbitration than one-time discriminators. Alternatively, scholars might investigate whether firms that employ mandatory arbitration provisions have a worse discrimination history than firms that do not employ such provisions.

Before concluding that mandatory arbitration is a good or bad idea, it is crucial to understand: (1) the risk-management role mandatory arbitration plays, and (2) the way mandatory arbitration interacts with liability insurance and other risk-management devices. This Article proposes an answer to the first question. The second question is empirical and requires further study.

¹⁵¹ To my knowledge, only one arbitration study considers the relationship between arbitration and other contractual provisions. See Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549, 580 (2003) ("Franchising parties who include provisions in their contracts limiting damages—those most concerned about the risk of excessive damages in court—are highly likely to opt for arbitration.").